Standard

| TRADING |

Trading Warrants and share instalments

Five pointers to successful trading

TRADING WARRANTS and share instalments requires a different approach to buying and selling shares, though there are some common characteristics.

Brett Duncan, Standard Bank's head of retail derivatives, has five key pieces of advice for anyone who would like to trade either warrants or Share instalments. An investor's time horizon and appetite for risk will determine whether he should be trading warrants or share instalments. share instalments are for traders with a slightly longer-term view (up to six months or more), whereas "higher risk" speculators with short-term views (up to six weeks) should choose warrants.

To begin with, he advises that the investor should evaluate whether or not he's suited to trading instruments such as warrants or share instalments. He notes that not everyone is suited to this and advises that investors must understand the risks attached to trading in these derivative products and have the time to check their positions at least on a daily basis.

The second piece of advice is to understand the risks and implement risk controls. Duncan advises one should always trade with stop losses when trading warrants or any geared instrument. Investopedia.com defines a stop loss as "an order placed with a broker to sell a security when it reaches a certain price. It's designed to limit an investor's loss on a security position." Duncan advises setting a stop loss on a warrant of 15% and 5% - 10% for share instalments. This means that if the instrument's price falls 15% below the price you paid, in the case of warrants, a sell order will be executed. Duncan quotes John Maynard Keynes in explaining why stop losses are important: "The market can remain irrational longer than you can remain solvent."

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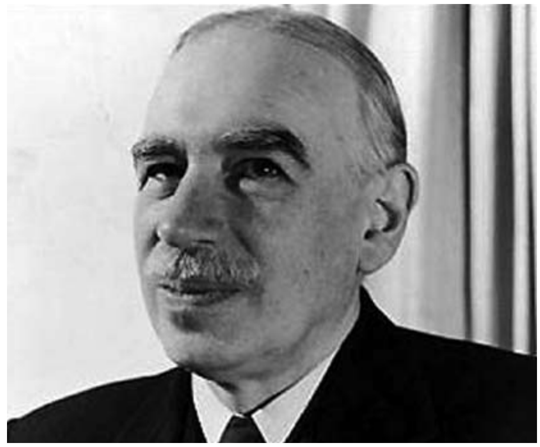
John Maynard Keynes



Some traders use trailing stop-loss orders. For a long position (a call warrant), the stop loss is set at a percentage level below the latest daily high for a warrant. The stop loss price is adjusted as the warrant price moves up and is only triggered if the warrant's price retraces by a set percentage from the new high.

Thirdly, Duncan advises warrant and share instalment traders never to become emotionally attached to their positions. This is easier said than done, as it's a very human reaction to hold on to losing positions – though this is not rational. A stop loss helps as it takes the emotion out of an exit strategy.

In this regard, Duncan advises a three-phase strategy: set your exit points (profit-taking levels), set your stop loss and set the time frame of the trade. He advises writing these three things down before you even execute a trade so that you do not allow emotions to interfere in taking a trading profit or limiting a trading loss.

> **Investors should avoid "overtrading" a warrants portfolio when they trade just for the sake of trading. They should rather make sure they have a solid reason for every warrants trade they make.**

- Duncan says that before you execute your trade you should decide when you'll exit. He advises taking half your profit once the warrant has appreciated by 20% and the other half once the warrant is 50% up from your entry price. "Don't be greedy. A warrants' portfolio is a long-term investment made up of short-term trades."
- The use of stop losses in warrants' trading is extremely important as a warrant will expire worthless if it's out-of-the-money. Duncan strongly advises against averaging down or rand-cost averaging (RCA) when trading warrants. RCA means buying more warrants as the price falls to reduce your average price per warrant. He says that having to use RCA means you got the trade wrong and you should rather exit.
- Set your time frame for investment and if this elapses without the desired financial outcome, you should exit to limit future losses due to the time decay of the warrant.

The fourth piece of advice Duncan gives is to find an angle. He says that we all have certain strengths and expertise in certain fields, for example the industry in which we work. "The fact is that in a market as diverse as ours, trying to know something about every listed company is impractical. Rather concentrate on a sector that you are specifically interested in or in which you have specific knowledge. Perhaps you work in retailing so you have an intuitive knowledge of retail stocks, then concentrate on trading warrants listed over shares in that sector."

Lastly, Duncan advises warrants and share instalment traders to be "original". In a nutshell this means adopting some contrarian thinking and being brave enough to back yourself against the herd.

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If you're specifically looking at the warrants market, Duncan offers three tips in selecting the right warrants:

- Always trade warrants with more than three months to expiry. This is due to the heavy time decay experienced in the last three months of a warrant, though short-dated warrants tend to have very high gearing, especially in at-the-money warrants.
- Trade warrants with between two and six times' gearing. Duncan says that trading with excessive gearing can make the management of stop losses exceptionally difficult. For example, if you trade in a warrant with 10 times' gearing, a move of just 1,5% - which is not uncommon in South Africa – will trigger your stop loss of 15%. In comparison, a warrant with five times' gearing will need a 3% move in the underlying share to trigger a stop loss.
- If time decay is an issue, trade in-the-money warrants.

When it comes to making the actual trade, Duncan says that the investor should use fundamental analysis to pick the stock that he wants to invest in and then use technical analysis – of the underlying share, not the warrant – to time his entry.

Duncan advises against trading in warrants that have a Delta of less than 10%. Leading from this, he says the investor should always make sure the chosen warrant suits his trade. For example, they should not be far out-of-the-money with a short time to expiry.

In practical terms, Duncan advises that an investor should invest about 20% of his total portfolio in geared instruments such as warrants and share instalments and then invest the rest in long-term instruments such as shares. He should rebalance his portfolio at regular intervals by investing a portion of his trading profits in his long-term portfolio or vice-versa. Investors might also consider using index warrants, which instantly diversify their warrants portfolio.

In addition, Duncan advises establishing a separate warrants trading account. The short-term nature of warrants trading means that the South African Revenue Service is likely to tax profits on warrants trades as income.

He says investors should avoid "overtrading" a warrants portfolio when they trade just for the sake of trading. They should rather make sure they have a solid reason for every warrants trade they make. When uncertain of the market's direction, sell down to the point where you'll sleep easily at night. Similarly, when in doubt "do nothing" and remain in cash.

Following from this, Duncan says that if you're trading badly, you should reduce both the number and the size of your positions, use tighter stop losses and liquidate your losing – not your winning – trades.

However, when you're trading well, let your winning trades run – with a trailing stop loss – and take partial profits. Then look to re-enter the position on any retracement. ¤

WARRANTS AND SHARE INSTALMENT TRADING PRODUCTS FROM ONLINE SHARE TRADING

ALL TRADERS should familiarise themselves with the intricacies of warrants and share instalments before they make their trades. However, the Standard's Online Share Trading offers a number of products and services that will make life a bit easier.

The Standard's Online Share Trading offers the following benefits for warrants traders who have accounts with it:

- The cheapest broking rates in South Africa at a flat R55 per trade (excluding VAT and statutory charges) for both warrant and share instalment trades in the group's special warrants accounts.
- Price matrices on all Standard Bank warrants.
- An online interactive warrants course (see www.warrants.co.za) and face-to-face classes for all its clients.
- Deltas, implied volatilities and time decay (theta).
- A warrants calculator to help you price warrants using an automated Black-Scholes model.
- A warrants filter to help you find both the full list of available warrants and what warrants exist over any one particular share.
- A daily newsletter to alert you to any announcements made by warrants' issuers (subscribe on www.warrants.co.za).
- A daily market report to provide both education and trading tips.
- Online introductory brochures for both warrants and share instalments (on www.warrants.co.za).
- An online warrants tutorial.
- Educational seminars that introduce investors to both warrants and share instalments.
- Standard Bank publishes a daily matrix of share instalment prices relative to the underlying share on the website www.warrants.co.za ¤

| SHARE INSTALMENTS |

Getting exposure to top shares at a discount

One of the JSE's best kept secrets

SHARE INSTALMENTS have been one of the JSE's best kept secrets. They do, however, offer a number of benefits of which traders in geared instruments should be aware and have a place in any leveraged trading strategy.

According to Brett Duncan, Standard Bank's head of retail derivatives: "share instalments are instruments that allow investors to gain exposure to some of the JSE's leading companies. The holder of the share instalment enjoys many of the benefits (capital growth and dividends) of directly owning some of the country's leading stocks without having to pay the full purchase price upfront."

A share instalment is simply a way of buying a JSE-listed share in two easy steps.

The first phase is an initial upfront payment that gives you exposure to the underlying shares. This exposure includes the right to receive all dividends paid on the underlying shares and to participate in the price movement of the underlying share. The share instalment price will track changes in the underlying share price.

The second stage is an optional payment (or exercise price) that can be paid at any time up to the share instalment's expiry. The owner of the share instalment takes full ownership of the underlying shares once the exercise price has been paid.

But there are other options to exercising the option.

Firstly, if investors wish to maintain their exposure to a particular share, they can sell out of an existing share instalment before it expires and reinvest the proceeds in a new share instalment, with a longer time to expiry, over the same underlying share.

Secondly, an investor who chooses not to exercise his share instalment because the underlying share price has fallen, could still receive a cash payment if the underlying share's price exceeds the share instalment's exercise price.

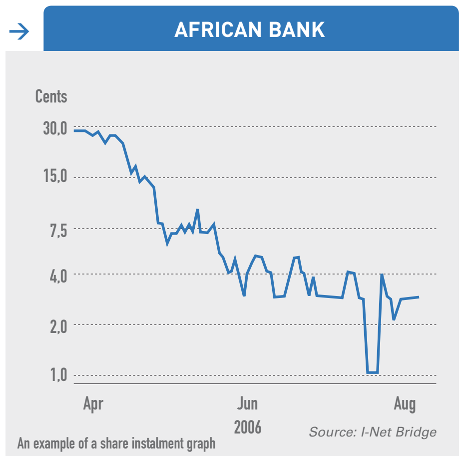
Lastly, an investor can simply sell his share instalment if he wishes to exit that investment.

Share instalments have a number of benefits.

- They provide geared share exposure as you only pay a portion of the total cost of investing in the underlying share but receive the full rand value of share price movements.
- They provide an enhanced dividend yield as share instalment owners receive the full rand value of the dividends paid on the underlying shares. The rand value of these dividends is a higher percentage than the dividend yield on the underlying shares because you have invested only part of the capital for the same dividend return. Dividends, including those paid to holders of share instalments, are tax-free in the hands of the recipient.
- Unlike futures, share instalments have no margin calls, and owners are not obliged to take up the underlying share at expiry. The maximum potential loss is limited to the initial investment.
- Investors have the opportunity to leverage their portfolios by replacing their investments in underlying shares with share instalments. The extra capital freed up through this action can be used to increase investors' overall exposure to the market, by buying extra share instalments, or to free up cash for other uses.
- share instalments are listed on the JSE and thus are both transparent and regulated in terms of the JSE's rules.

Duncan says that share instalments are a lower risk option than warrants in the short term. They can be used to boost the yield of a long-term "buy and hold" investment portfolio.

Standard's Online Share Trading offers share instalments at a flat brokerage of R55 (excl VAT and other statutory costs) if traded in the special warrants account. It also has the share instalment matrices on its website. ¤



An example of a share instalment graph

QUIZ

EACH WEEK we'll publish three questions related to the week's content. At the end of the 12 weeks Online Share Trading will give R10 000 worth of Satrix shares in an online account to the reader who has correctly answered each week's questions.

To take part in the draw just answer the following questions and submit your answers either online to SBquizz@finweek.co.za or by fax to (011) 884-0851.

1. What's the name of the trading strategy that places a sell order when a warrant or share instalment falls to a specific price?
2. What level of gearing should warrants have for you to trade them?
3. What type of geared instrument allows you to enjoy many of the benefits of (capital growth and dividends) of directly owning some of the country's leading stocks without having to pay the full purchase price upfront? ¤

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